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ENERGY/KPC/KOK/DLW/RHG

Decision 06-04-014 April 13, 2006

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

Application of SOUTHERN CALIFORNIA EDISON COMPANY (U-338-E) for authority to issue, sell and deliver one or more series of Debt Securities and guarantee the obligations of others in respect of the issuance of Debt Securities, the total aggregate principal amount of such indebtedness and guarantees not to exceed $2.0 billion; to execute and deliver one or more indentures; to sell, lease, assign, mortgage, or otherwise dispose of or encumber utility property; to issue, sell and deliver in one or more series, an aggregate amount not to exceed $500 million par or stated value of Cumulative Preferred Stock -- $25 Par Value, Cumulative Preferred Stock -- $100 Par Value, Preference Stock or any combination thereof, and guarantee the obligations of others in respect of the issuance of that Stock; and for an exemption from the Commission's Competitive Bidding Rule.	Application 05-02-018 (Petition for Modification Filed November 17, 2005)

SUPPLEMENTAL OPINION

Summary

This decision grants in part, and denies in part, the authority requested by Southern California Edison Company (SoCal Edison) in its Petition for Modification of Decision (D.) 05-08-008 (Petition). This

decision authorizes the issuance of certain new financing structures and subordinated debt with interest deferrable features, with maturities of up to eighty (80) years. Authority for extending the maturities of any other types of debt or securities is denied without prejudice.

Pursuant to Rule 47 of the Commission's Rules of Practice and Procedure, SoCal Edison requests authorization, to increase the maturities of the Debt Securities granted in D.05-08-008, up to a maximum term of eighty (80) years.

Notice of the filing appeared on the Commission's Daily Calendar of November 22, 2005. No protests have been received.

Background

On August 25, 2005, by D.05-08-008, in Application (A.) 05-02-018, the Commission granted SoCal Edison the authority to (1) issue Debt Securities in an aggregate principal amount not to exceed $2.0 billion; and (2) issue one or more series of Cumulative Preferred Stock--$25 Par Value, $100 Cumulative Preferred Stock--$100 Par Value and Preference Stock, or any combination thereof (Preferred Stock), in an aggregate amount of up to $700 million par or stated value.

The Debt Securities include first and refunding mortgage bonds, debt secured by a pledge of accounts receivable, debentures, notes, preferred securities, overseas indebtedness, foreign currency denominated securities, commercial paper, extendible commercial notes, floating or variable rate debt, credit or loan agreements, and other evidences of indebtedness. The Debt Securities may bear a fixed, floating or variable rate of interest and may be issued at par or with an original issue discount or premium. The Debt Securities will be issued with maximum maturities of 40 years for first and refunding mortgage bonds, and 49 years for debentures, notes, preferred securities, and credit or loan agreements.

Debentures, or other unsecured Debt Securities, may also be issued as part of an issuance of trust preferred securities. In such an instance, SoCal Edison would create an affiliate in the form of a trust or other entity that would issue preferred securities to the public. The preferred securities would represent an interest in the preferred stock issued by SoCal Edison to the trust, and would also be guaranteed by SoCal Edison.[1]

On September 1, 2005, SoCal Edison paid the fee for the D.05-08-008 debt authority, as required by Public Utilities Code § 1904(b).

Modification Sought

SoCal Edison states, in the Petition, that during the last six months of 2005, Standard and Poor's Rating Services (S&P) and Moody's Investor Service (Moody's) issued new guidelines regarding the amount of equity credit attributable to preferred stock structures. SoCal Edison points out that the new guidelines led most of the investment banks that underwrite SoCal Edison's securities to propose new financing structures, which would serve as alternatives to SoCal Edison's preferred stock, including preference stock. According to SoCal Edison, the new financing structures allow for the issuance of equity-like securities which are tax-deductible, and result in lower cost equity financing for borrowers when compared to traditional perpetual (no maturity) preferred stock. SoCal Edison asserts that one of the requirements to obtain the higher equity credit is to increase the maturity or term of the security.

[1] Pacific Gas & Electric Company and San Diego Gas and Electric Company have formed special purpose entities and issued deferrable interest securities since they were introduced in the market in late 1993.

A key component of the new structures is the extended maturities. In order for the new securities and SoCal Edison's preferred stock to receive a similar amount of equity credit from the rating agencies, the new securities must have maturities of greater than 49 years. The longer the maturity, the more the rating agencies consider the security to be similar to common equity, thereby increasing the equity credit.

There are two primary goals of the new financing structures. First, SoCal Edison asserts that the new securities would receive a similar or greater amount of equity credit from the rating agencies than SoCal Edison presently receives for its preferred stock. Second, unlike traditional preferred stock, SoCal Edison indicates that it would receive a tax deduction for the periodic cash distributions that SoCal Edison would pay on the new securities, thereby reducing their costs.

According to SoCal Edison, the financial markets have not settled on the structure of the new securities as of yet, but some of the proposals SoCal Edison has received specify that securities could be issued with maturities of up to 80 years and unsecured debt securities could be issued with a shorter term such as 60 years, depending on how the market develops.

While the new structures are still evolving, one format would have SoCal Edison issue subordinated debt to a trust which is 100% owned by SoCal Edison. The trust would issue "trust preferred securities" to the public. The trust preferred securities and the subordinated debt issued to the trust would bear the same interest rate and have the same longer maturities. This structure is similar to the trust preferred securities that have been described in D.05-08-008 and previous SoCal Edison financing applications approved by the Commission.[2]

SoCal Edison indicates, in its Petition, that its proposed new financing structures, with longer maturities, are similar to a new hybrid instrument called enhanced capital advantage preferred securities, or "Ecaps," introduced by the Lehman Brothers to the financial market during the third quarter of 2005. Ecaps have a 60-year maturity, twice as long as the typical trust preferred security. Ecaps are more equity-like and have mandatory deferral features, such as an equity issuance requirement, with up to a 12-year deferral period. Edison claims that this hybrid product affords issuers the maximum amount of equity credit for a lower price and is already being hyped as the replacement for trust preferred securities and mandatory convertible preferreds. SoCal Edison asserts that the cash flows of trust preferreds are considered interest rather than dividends for tax purposes, meaning they are deductible. Edison points out that, historically, the only downside of trust preferreds is that their debt-like characteristics meant issuers received considerably less equity credit from rating agencies than with traditional preferred stock. Moody's currently assigns zero equity credit to trust preferreds, but assigns 75% equity credit and 25% debt for Ecaps. S&P plans to assign 60% to 70% equity credit for Ecaps.

When A.05-02-018 was filed, SoCal Edison indicates that it did not anticipate the development of new types of securities, such as the Ecaps. The Petition states that if Ecaps are accepted by the rating agencies as an equity substitute and are deemed tax deductible by the Internal Revenue

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[2] D.03-12-004 dated December 4, 2003 and D.00-10-063 dated October 19, 2000, granted SoCal Edison with conditions, the authority to use a special purpose entity for the purpose of issuing trust preferred securities as part of its overall request to issue debt and equity securities.

Service (IRS), SoCal Edison would treat these securities as preferred stock in its ratemaking capital structure in subsequent cost of capital proceedings.

SoCal Edison also requests, in the Petition, to have the ability to issue subordinated debts, with longer maturities, directly to the public.

Discussion

D.05-08-008 provided SoCal Edison the ability to issue debentures or other unsecured debt securities as part of an issuance of trust preferred securities. The similar but new structures may carry distinct advantages to the utility and its ratepayers (equity features, equity rating benefits, interest payment deferral, and some tax advantages). Therefore, we find SoCal Edison's presentation of Ecaps or Ecaps-like instruments, as discussed in the Petition, reasonable and worthy of consideration.

In addition, SoCal Edison indicates that it has received proposals from investment banks, whereby subordinated debt may be issued directly to the public rather than to an intermediary trust. SoCal Edison claims that while such an issuance of subordinated debt is not a preferred security, the issuance can still be structured with similar characteristics as the trust preferred securities and would still be considered to be of high-equity content. As stated earlier, the longer the maturity of the new securities, the more the rating agencies would consider the security to be similar to common equity, thereby increasing the equity credit.

In D.95-09-023 dated September 7, 1995, in A.95-06-060, the Commission granted Pacific Gas and Electric Company (PG&E), authority to guarantee or otherwise secure, the deferrable obligations and securities, commonly know as Quarterly Income Preferred Securities (QUIPS) and Monthly Income Preferred Securities (MIPS), issued by special purpose vehicles, formed for the purpose of effecting the financing, with the proceeds of the financing to be loaned to PG&E.[3]

[3] QUIPS or MIPS proceeds will be loaned by the special purpose vehicle to PG&E in the form of subordinated 30-50 years debt with similar economic terms as QUIPS or MIPS.

In the same decision, PG&E was also authorized to directly issue Quarterly Income Debt Securities (QUIDS) and Monthly Income Debt Securities (MIDS) or other subordinated deferrable interest debentures to investors for up to 30 to 50 years, without the use of a special purpose vehicle or business trust. The deferrable interest securities would be debt instruments with interest deferrable features similar to the QUIPS and MIPS.

Section 816 of the Public Utilities Code states:

> The power of public utilities to issue stocks and stock certificates or other evidence of interest or ownership and bond, notes, and other evidences of indebtedness and to create liens on their property situated within this State is a special privilege, the right of supervision, regulation, restriction, and control of which is vested in the State, and such power shall be exercised as provided by law under such rules as the commission prescribes.

The Commission's power to grant or deny authority to issue debt securities implies the power to grant authority with qualification or condition. The Commission reviews the stock and security transactions of a utility based on the type of securities that are currently available in the domestic or foreign capital markets, in the manner, and at times, subject to limitations, set forth in the financing application.

Presently, securities or debt instruments are not fashioned or marketed with eighty years maturity in the capital markets. Currently, it does not appear to be in the public interest to extend the maturities of these types of securities. SoCal Edison's request for blanket authority to have up to 80-year maturities for all types of Debt Securities authorized in D.05-08-008 is denied without prejudice.

However, we will authorize SoCal Edison to guarantee or otherwise secure, through one or more agreements, the new financing structures, enhanced capital advantage preferred securities or similar hybrid debt instruments with maturities of up to eighty (80) years. We will also authorize SoCal Edison to issue subordinated debt with maturities of up to eighty (80) years, provided the subordinated debt carries interest deferrable features, similar to the new financing structures.

We remind SoCal Edison that it will be expected to demonstrate and support, in a future proceeding, that the specific capital costs incurred to issue hybrid debt instruments, were appropriate and beneficial under the circumstances. We will limit ratepayers' responsibility for expenses that may arise from interest on taxes that may be assessed by the IRS if the expected tax advantages do not materialize (back taxes), as well as any penalties or interest on penalties. Ratepayers will only be responsible for (1) back taxes, to the extent that the benefits of reduced taxes were flowed through to them, and (2) interest on ratepayer recovered back taxes, calculated at no more than the rate earned on prime, three-month commercial paper, as reported in the Federal Reserve Statistical Release, H-15. Ratepayers will not be responsible for any penalties associated with the use of these instruments to reduce taxes, or any interest assessed on the penalties.

Our finding that the issuance of the above debt structures through a special purpose entity or directly to investors without the use of a special purpose entity, will benefit both SoCal Edison and its ratepayers does not constitute a blank check for including the resulting cost of capital in its capital structure in a later proceeding. The Commission reserves the right to make a full assessment and measurement of any new financing structures, Ecaps, subordinated debts, and how the market for such securities develops, at a future date.

As required in D.05-08-008, the following conditions in connection with the use of a special purpose entity apply:

1. SoCal Edison's subsidiary shall be created solely for the purpose of issuing securities to the public or privately to support SoCal Edison's operations or service.

2. SoCal Edison shall have 100% ownership and control of the subsidiary.

3. The activities of the subsidiaries shall be subject to federal or state securities regulation and to the regulation of the Commission through its oversight of SoCal Edison's financing activities.

4. Savings resulting from the difference in costs between raising capital through the new financing structures and a traditional Preferred Stock issuance will be passed to ratepayers in the annual revisions of SoCal Edison's authorized cost of capital.

Other new financing structures that will be developed and may become available in the capital market in the future are subject to Commission review or approval.

Assignment of Proceeding

Kevin P. Coughlan is the assigned Examiner in this proceeding.

Comments

On March 14, 2006, the draft decision of Examiner Coughlan was mailed to the parties in this matter, in accordance, with § 311(g) (1) and Rule 77.7 of the Rules of Practice and Procedure. On April 3, 2006, SoCal Edison filed comments on the draft decision.

SoCal Edison alleges that the interest rate used in the draft decision to calculate interest on back taxes is inaccurate and instead should be equal to the rate that may be assessed by the IRS and state taxing authorities. SoCal Edison points out that the three-month commercial paper rate, as reported in the Federal Reserve Statistical Release, H-15 may be far lower than what may be assessed.

The Commission has repeatedly held that the 3-month commercial paper rate represents a reasonable cost for certain financing, under and over collections, interest-bearing memorandum accounts, and interest on taxes.

In D.95-09-023, Pacific Gas & Electric Company was granted authority to issue subordinated deferrable interest debentures, commonly known as Quarterly Income Debt Securities and Monthly Income Debt Securities, which in the mid-1990's were a new form of debt that carry distinct advantages (equity features, interest payment deferral, bond rating benefits, and some tax advantage). The Commission found that ratepayers' responsibility for interest, that may arise from back taxes, that may be assessed by the IRS, if the expected tax advantages did not materialize, was limited to no more than the rate earned on prime, three-month commercial paper.[4]

In D.95-08-048, Southwest Gas Corporation was permitted to issue, through a financing subsidiary, an equity security that will be treated as a form of equity for financial reporting purposes, while allowing it to deduct the cost of such security for tax purposes. Again, ratepayers' responsibility for interest on back taxes was set at no more than the rate earned on prime, three-month commercial paper.[5]

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[4] D.05-09-023, page 13, paragraph # 4.
[5] D.95-08-048, page 4, paragraph #3.

Since the debt instruments are structured to reduce costs and the utility is willing to issue them at its own risk, it should be the stockholders who should absorb certain costs if the tax benefits do not materialize. Stockholders should be responsible for penalties, interest on penalties, and the difference between what may be assessed by the IRS and state taxing authorities and the three-month commercial paper rate.

We find no merit in SoCal Edison's argument that the 3-month commercial paper rate, as reported in the Federal Reserve Statistical Release, H-15 is the incorrect rate to use.

Findings of Fact

1. SoCal Edison, a California corporation, is a public utility subject to the jurisdiction of this Commission.

2. A portion of SoCal Edison's Petition is for proper purposes and not adverse to the public interest.

3. The new securities transactions are subject to the following conditions:

    a. SoCal Edison's subsidiary shall be created solely for the purpose of issuing securities to the public or privately to support SoCal Edison's operations or service;

    b. SoCal Edison shall have 100% ownership and control of the subsidiary;

    c. The activities of the subsidiaries shall be subject to federal or state securities regulation and to the regulation of the commission through its oversight of SoCal Edison's financing activities; and

    d. Savings resulting from the difference in costs between raising capital through the new financing structures and a traditional Preferred Stock issuance will be passed to ratepayers in the annual revisions of SoCal Edison's cost of capital.

4. For new financing structures, Ecaps, and similar hybrid debt instruments, ratepayers shall not be responsible for penalties or interest on penalties, if the expected tax advantages do not materialize. Ratepayers will be responsible for any back taxes to the extent that benefits of reduced taxes were previously flowed through to them. Ratepayers will also be responsible for interest on any ratepayer recovered back taxes, calculated at the prime, three-month commercial paper rate, as reported in the Federal Reserve Statistical Release, H-15.

5. Notice of the filing of the Petition appeared on the Commission's Daily Calendar of November 22, 2005. There is no opposition to the Petition and there is no reason to delay granting the request described therein.

Conclusions of Law

1. A public hearing is not necessary.

2. The Petition should be granted to the extent set forth in the order that follows.

3. A blanket provision to have 80 year maturities for all types of debt securities should be denied without prejudice.

4. The following order should be effective on the date of signature.

SUPPLEMENTAL ORDER

IT IS ORDERED that:

1. Southern California Edison Company, under the financing authority granted by Decision (D.) 05-08-008, may issue new financing

structures, enhanced capital advantage preferred securities, similar hybrid debt instruments, and subordinated debts discussed in this order, with maturities not to exceed eighty (80) years.

2. The new financing structures, enhanced capital advantage preferred securities, hybrid debt instruments, and subordinated debts may be issued to a trust or directly to the public.

3. The new financing structures, enhanced capital advantage preferred securities, hybrid debt transactions, and subordinated debts shall be subject to conditions consistent with our findings.

4. A blanket provision to have 80 year maturities for all types of debt or securities under the financing authority granted in D.05-08-008 is denied without prejudice.

5. Ratepayers shall not be responsible for penalties or interest on penalties, and other expenses that may arise from taxes that may be assessed by the Internal Revenue Service, if the expected tax advantages of the new financing structures, subordinated, and hybrid debt transactions do not materialize. Ratepayers shall be responsible for any back taxes, to the extent that the benefits of reduced taxes were previously flowed through to them. Ratepayers shall be responsible for interest on ratepayer-recovered back taxes, calculated at the prime, three-month commercial paper rate, as reported in the Federal Reserve Statistical Release, H-15.

6. In all other respects, D.05-08-008 remains in full force and effect.

7. Application 05-12-018 is closed.

This supplemental order is effective today.

Dated April 13, 2006, at San Francisco, California.

MICHAEL R. PEEVEY
President
GEOFFREY F. BROWN
DIAN M. GRUENEICH
JOHN A. BOHN
RACHELLE B. CHONG
Commissioners